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DOW THEORY LETTERS

"THE MARKET AS INTERPRETED UNDER THE DOW THEORY"

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A PRIMARY BULL SIGNAL? (Question from San Gabriel, Cal.) "One of the things that has puzzled me is that rails made a high several years ago which, up to the past week or so at least, has not been equalled or bettered. It would seem that until such time as the rails confirm industrials by passing the old highs, there would still be some doubt as to the validity of the bull trend...I would be very interested in your analysis of this point."

ANSWER. In 1956 rails hit their bull market high of 181.23. The severe reaction that followed wiped out almost 50% of the rail average price (Dec. 1957 lows, 95.98). They have not since returned to their 1956 highs. Yet it is a principle of the Dow Theory that the primary trend is taken to continue until a valid signal is given which definitely indicates a reversal of the primary trend. No such signal has been given since this bull market began in June of 1949. Regardless of the fact that rails have not confirmed the penetration of the 1956 industrial highs (521.05) several months ago, we have been operating as if a rail confirmation was "in the cards."

Many subscribers have been extremely dubious of the rails since the lows of 1957. Yet since then rails have advanced in the most spectacular fashion. As late as last September it was necessary for me to write a piece in which I insisted that the rail average was still a true indicator of the trend of shipping and transportation in this country. The feeling at that time was that rails were finished as an industry. Congress and the public were sure that the carriers were headed for mass bankruptcy, and a number of outstanding analysts were in full agreement. Rails since then have far out-performed industrials in percentages, and in doing so, have mocked the fears of even the presidents of the railroads.

I wrote on Sept. 13, 1958, when an industrial penetration of the 521.05 bull market high seemed anything but a foregone conclusion: "I believe the rails will confirm the breakthrough of the industrials at the top of the "line," and I believe that before this bull market is over they will give a primary bull signal by going through their 1956 highs of 181.23." Many readers wrote me at the time demanding to know if I was serious. Now, with 20 points to go for a rail confirmation of the industrial breakthrough, that prediction seems much less far-fetched.

If rails now penetrate their 1956 highs I would be forced to say, what of it! We have been operating for fifteen months on the premise that they would confirm. True, this would be a primary bull signal and a verification of the fact that we have been in a bull market since June, 1949. But this should not come as a surprise to readers of these letters.

It is interesting to note that there is a precedent for this belated rail move. In 1933, the rails collapsed; they did not return to their highs again until 1936. At the time of the final confirmation, Robert Rhea said, "The persistent failure of the rail average to confirm the industrial group in the establishment of new bull market highs seemed to annoy many of those students of the price movement who always become impatient when the dual indicators fail to perform as desired. These individuals lost sight of the fact that Dow's Theory...does not stipulate that the penetration of critical points is needed before drawing valid inferences as to bullish or bearish trends, nor does it require confirmation in the same week, month, or year." He adds, "The fact that the rails finally bettered the 1933 highs is of no particular forecasting significance because of the extreme age of the older objective. No similar condition has ever been recorded in the averages." (September 26, 1936)

If the rails now confirm, history will have repeated itself. In that case, everything Rhea said 23 years ago will apply to the market today.

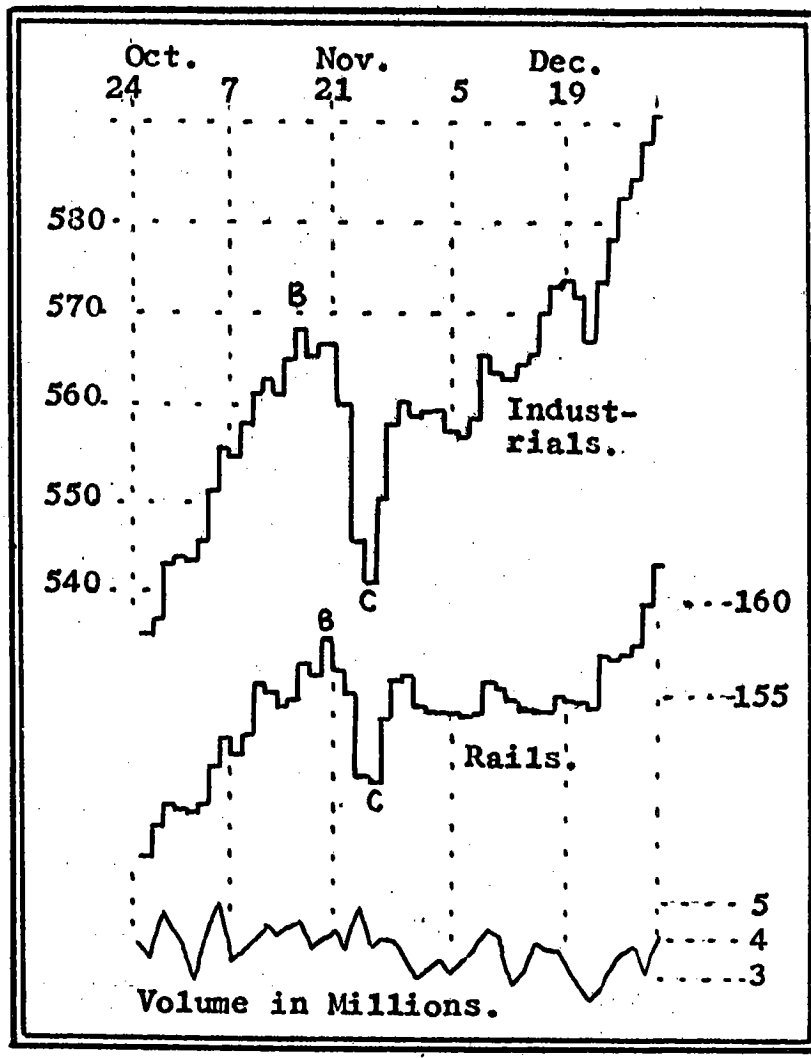
IDIOT'S DELIGHT. A recent large advertisement is worthy of comment here. The organization in question, having proved themselves less than competent as analysts of the short-term, now assumes the position of God and hastens to tell us that the market may double in four years. Of such madness is a third phase "boom" made.

PRICE MOVEMENTS. Last Friday the long awaited rail penetration of point B became an accomplished fact. This confirmation of the mid-December industrial advance through point B was, of course, a prediction of higher prices for an indeterminate period of time to come. The Dow Theory indicates direction, not duration or extent.

In the vast majority of cases, a panic decline such as the B-C move (see chart) has been followed by a later decline in which both averages violate the first decline bottom. It is indicative of the strength of this market that the C point was not penetrated by either average. Instead industrials advanced over their highs and rails, after a longer period of accumulation, followed suit.

We now have a bullish signal combined with a huge short position which is "locked-in" and becoming increasingly desperate. The institutions and large investors have supplied most of the buying power up to this point. In my opinion, we may soon be seeing the beginning of real public participation in this bull market. The signs will be higher volume, more erratic movements, and greater activity in the low-priced issues.

REACTION? Over and over again some of the larger investment services and many professional writers have promised us a severe correction of the advance since the October, 1957 lows. The question now becomes, will they ever be right? While there will be future reactions, my feeling is that the investment fraternity (to say nothing of the public) will all have turned rampantly bullish at about the time of the next reaction. In so doing, they will continue to be wrong. This is no idle cynicism; it is an observation based on history. The majority of professional opinion is seldom correct. In all probability, the next reaction will come when few if any economic uncertainties are visible on the horizon.



STOCKS. I continue to dislike the following: STANDARD OF JERSEY, SOCONY, ROYAL DUTCH, and most of the other international oils.

The following look good on my charts: BUDD CO., WESTINGHOUSE AIR BRAKE BALTIMORE & OHIO R.R., UNION PACIFIC, NEW YORK CENTRAL, PENNSYLVANIA R.R., JONES & LOUGHLIN. As mentioned in the last letter, most of the rails are in bullish technical patterns and many have broken through to new highs for the year since the last writing. (written the morning of January 7, 1959)